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Great Britain Goes Off the Gold Standard

THE announcement by Great Britain that she had been compelled to abandon temporarily the gold standard marks a new and more momentous climax to the difficulties against which Europe has been contending. Commencing with banking troubles in Vienna, the financial conflagration has spread rapidly throughout Central Europe, finally extending across the Channel to London, a name heretofore regarded as practically synonymous with stability and economic strength. What has occurred is a temporary breakdown of international confidence, which has disrupted the normal credit relationships and induced lenders everywhere to want to have their money at home. If ever there has been a convincing demonstration of the absolute interdependence of nations economically, the events of the past Summer have been that.

When the troubles first broke out in Austria, and later extended to Germany, London, true to its traditions as a great international money center, did all in its power to extend help. In the Austrian crisis the Bank of England lent $21,000,000 to the Austrian Government to help tide over a critical period, and, later when the panic had spread and involved Berlin, participated to the extent of $25,000,000 in a central banking credit to the Reichsbank. In addition, much assistance was also extended through private banking channels. With the closing down of the German banks, however, apprehensions began to be felt as to the possible repercussions on London which was known to have large commitments in Germany. Thus, almost over-night, London too found its foreign creditors clamoring at its doorstep for a return of their funds.

The Battle for the Pound

Since then the British Government has been engaged in a heroic battle to save the pound. Between the middle of July and the first of August gold holdings of the Bank of England fell by £32,000,000 to £133,800,000 ($651,000-000), the lowest since November 1929. To check this withdrawal of funds, strengthen sterling, and protect the gold reserve, the Bank of England raised the discount rate from 2½ to 4½ per cent, and on August 1 contracted a joint credit of $250,000,000 from the Bank of France and the Federal Reserve Banks. This checked the outflow of gold momentarily, but only at the cost of drawing on the proceeds of the credit, since the flight of capital continued. About this time came the report of Parliament's Economy Committee, appointed last March to study the problem of balancing the budget. This report, revealing the unsatisfactory position of the nation's finances, denouncing as unsound the practice of continuous borrowing to support the dole, and predicting a budgetary deficit of £120,000,000 for the year 1932-33, crystallized the already growing uneasiness regarding British credit. Coming on top of the alarm caused by the German situation, it added impetus to the movement to get money out of England. By the end of August, the proceeds of the central banking credit had been exhausted, and Great Britain was up against the necessity of taking more drastic steps to restore confidence or of abandoning the gold standard.

In this emergency, Great Britain chose to continue the fight. To do so, the first step was to balance the budget and put the finances of the Government on a sound basis. Such a program, however, involved reductions in the unemployment benefits to which the majority of the Labor Party would not agree, thus resulting in the downfall of the Labor Ministry and the formation of a new National Coalition Government, headed by Mr. MacDonald. Both the New York and Paris money markets gave immediate and willing cooperation to the new Government by furnishing them additional credits to the extent of $400,-000,000 for the support of sterling exchange.

These evidences of determination on the part of the British Government to put its financial house in order served for a time to quiet somewhat the alarm among holders of sterling. The new Government announced its intention to balance the budget, and on Sep-

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tember 10 introduced into Parliament its program for meeting the deficit. Had it been possible to carry through the measures proposed without serious opposition it is possible that confidence might have been restored and the situation saved. Unfortunately, the British public was far from a unit in accepting the measures of economy. A large section of the Labor Party had disavowed Mr. MacDonald, and consistently declared its opposition to cuts in the dole and to the general policy of reducing wages. On September 15 reports of unrest in the British Navy, following the announcement of pay cuts, injected a new note of alarm into the situation, while growing talk of an impending general election added still further to the increasing nervousness. As a result, the foreign exchange situation suddenly became acute again, and withdrawals quickly ran through the balance of the $400,000,000. The London market sustained losses of nearly $1,000,000,000, met partly from gold and foreign currency holdings of the Bank of England and partly from the proceeds of the two foreign loans already referred to. To prevent further losses the Government was obliged finally to give up the fight and, by suspending the provision of the Gold Standard Act of 1925 requiring the Bank to sell gold at a fixed price, permit sterling exchange to find its own level.

Failure to Balance Trade the Fundamental Difficulty

A summary of the various causes which have forced England off the gold basis would be very superficial if it attached too much importance to an unbalanced budget, which is a familiar phenomenon of depression. Great Britain is by no means the only country which has failed to balance its national finances; even the United States has failed to do so, and the fact that this is the case has occasioned no great amount of uneasiness regarding the Government's credit or the position of the dollar.

With Great Britain, however, the public has come to regard the deficit as not merely a passing phenomenon, but as the outward symptom of a much more serious maladjustment, namely, failure to balance the country's foreign trade. What has stirred the apprehension of the public, not only in foreign countries but in Great Britain as well, has been the apparent unwillingness of the British people as a whole to tackle the problem at its core, that is, by reducing production costs to levels permitting British goods to compete on favorable terms once more in foreign markets.

In the last issue of this Bank Letter, we discussed at some length the question of British production costs, and indicated our views as to the factors largely responsible for the tendency for British goods to sell out of line, namely, (1) failure in many cases to thoroughly modernize industrial equipment and methods, and (2) the comparatively high labor cost attributable to trade union resistance to readjustment of wages in line with lower prices.

In connection with the wage controversy, we pointed out that much of the difficulty dates back to the different financial policies pursued by Great Britain and rival nations after the war. To quote from our last Letter,—

> At that time Great Britain's principal Continental competitors found their exchanges so heavily depreciated as to make restoration to parity out of the question, hence most of them simply accepted the current levels of exchange as permanent and adjusted their currency systems accordingly. Great Britain, however, with a much less depreciated exchange and with the prestige of London as an international money center to safeguard, declined to follow this policy of repudiation and elected the more difficult task of restoring the value of the currency to par. Such a policy necessarily involved a decline in the price level, which, if unaccompanied by a corresponding reduction in money incomes—that is, wages and salaries—was certain to lay a heavy burden of cost upon British industry. Although a reduction of money incomes in keeping with a decline of prices would not have involved any sacrifice of real income or lowering of the standard of living of British workers, the attitude of British labor has been consistently opposed to any concessions in this regard, with the inevitable result that production costs have been kept up and British prices have tended to be higher than those of competing goods. The fact that British labor is so strongly unionized has been one important reason for this inelasticity in the wage level, and the effect of the dole has likewise been to prevent necessary wage adjustments to meet altered conditions by diminishing the compelling influence of unemployment.

Many British factories unquestionably rank among the most modern and efficient in the world and the indictment of the failure to modernize can be applied more to the older British industries, such as the cotton, iron and steel industry and coal mining.

These three great industries have been built in the past upon the advantage of early adoption of machinery methods and on cheapness of production. The later spread of industrialization, particularly in the Far East, wiped out most of these advantages and at the end of the short post-war boom the three British key industries found themselves burdened with over-capacity, over-capitalization, high taxes and obsolete equipment. A large portion of former foreign markets had been lost, while curtailed production increased unit costs and reduced profits, already small in relation to invested capital, to the vanishing point. Steady growth of unemployment followed, which made workers reluctant to speed up production and thus held down the productivity of labor. As unemployment increased opposition to the introduction of modern methods and much needed reorganization grew stronger. Following are some contrasts in the industrial efficiency in the three oldest British industries and their American counterparts.

	United States	Great Britain
Cotton Industry:		
Number of ordinary looms*	134,000	679,000
Number of automatic looms*	565,000	14,000
Coal Industry:		
Output per worker in tons	966**	281***
Amount of coal mined by machinery	over 70%***	23%***
Iron and Steel Industry:		
Basic open hearth steel—per cent of total output	about 85%†	about 65%†
Number of furnaces in operation		632**
Furnaces with capacity 100 tons or more		32**

*Figures of the International Cotton Federation in Manchester
** in 1926. *** in 1927. † in 1928.

In the best cotton mills of the United States, equipped with automatic looms, weavers with unskilled assistants frequently tend 60 or more looms, while in Lancashire the majority of weavers tend only four ordinary looms. The following statement by the International Cotton Federation in Manchester together with the figures given above, is very illuminating as an indication of why certain classes of British goods are having difficulty with foreign competition:

> It is estimated, on nearly complete actual returns from all countries, that Lancashire has 678,794 ordinary looms hitherto worked on the system of four ooms to a weaver and only 14,105 automatic and semi-automatic looms. Her chief competitors have much larger proportions of automatic plant. The United States has 133,631 ordinary looms, 532,176 automatic, and 33,148 semi-automatic looms; Germany has 24,626 automatic to 199,451 ordinary looms; France 17,500 automatic to 182,600 ordinary; Japan 15,000 automatic to 57,466 ordinary; and Italy 26,800 automatic and semi-automatic to 119,700 ordinary. The world totals are 2,335,296 ordinary, 661,023 automatic, 53,459 semi-automatic.

Because of these adverse influences affecting the export trade, unemployment in the export industries has been more or less chronic ever since the war, with resultant steady demands on the British Treasury. Moreover, the restriction of exports has tended to unsettle the trade balance, thus forcing the Bank of England to maintain an artificially high bank rate in order to protect the exchange. And this in turn not only penalized British industry unnecessarily, but had the effect of drawing to the London market a large amount of idle money, the later sudden withdrawal of which in time of danger precipitated the crisis.

Proposed Remedies

Such being the situation, what were the proposed remedies?

The growing sentiment in favor of protection has given the protective tariff an important place in the platform of the Conservative Party, and it is gaining adherents among the Liberals and Laborites as well. Though traditionally a free trade country and naturally reluctant to abandon a principle upon which she has founded her economic development, England has begun to have serious doubts as to the practicability of attempting to uphold almost alone the free trade idea in a world more than ever committed to the policy of exclusion. Moreover, with British goods suffering from foreign competition not only abroad but even in the home market, owing to relatively high production costs, what is more natural than to clap on a tariff to preserve the home market at least from foreign incursions? Obviously, such a policy is not calculated to help British exports, but if it protects the home market this should tend to correct the trade balance and permit an expansion of home production for home consumption that would relieve unemployment and lessen the burden of the dole upon the budget. At least so runs the argument. Without attempting to debate the advantages and disadvantages of a protective tariff for England, it suffices to say that it was inadequate for the present emergency, owing to the importance of the time element.

The program of the Coalition Government was embodied in the revised budget submitted by Mr. Snowden to Parliament on September 10. It called for far-reaching increases in taxation and reductions in expenditures. On the side of revenue, it raised the basic income tax rate from 22½ to 25 per cent, with reductions in the present scale of exemptions and allowances, and increased the supertax 10 per cent on incomes over £2,000. It increased the levies on beer, tobacco and amusements, and raised the tax on gasolene by twopence (4 cents) a gallon to eightpence (16 cents). On the side of economies, it called for pay cuts in practically all departments of the government, including the Army and Navy, civil servants, school teachers, and police. In addition, it cut the sinking funds, and also the Road Fund. More important of all, however, was a cut of 10 per cent in the dole, and increased contributions by workers and employers to the unemployment insurance. Thus, the Government endeavored to spread the burden equally, while at the same time recognizing the fundamental principle that no mere balancing of the budget which drew from the capital resources of the country to support a scale of industrial costs too high for industry to pay its way could hope to succeed.

Unfortunately, however, the British Trades Union has been unable to see the situation in this light. When the supply of funds available for the dole runs short, they know where they can go to replenish the till, as indicated by the following quotation from the manifesto issued by the British Trades Union and Labor execu-

tive committee at the time of the downfall of the Labor Government,—

> Four thousand millions (about $20,000,000,000) in British capital is invested abroad. Great Britain is still one of the greatest creditor countries. We are still adding to our national assets. The taxable capacity of the country is not exhausted. The immediate situation can be met without further depleting the slender means of the poor and without restricting national and local expenditure directed to the development of the country's resources.

The quotation reflects the idea widely prevalent not only in Great Britain but elsewhere as well that the higher incomes afford a legitimate and practically inexhaustible field for public exploitation. It is forgotten that to the extent that taxes are imposed to support unproductive expenditure, by just so much is there a diminution in the proportion of the national income available for reproductive purposes. One cannot have one's cake and eat it too.

All of which has been understood very well indeed by holders of sterling exchange and securities, both at home and abroad, even though it apparently has not been clear to a large section of the population in England. Hence the renewal of the flight from the pound once doubts began to arise as to the Government's ability to carry through its program of financial reform. On September 20 came the announcement of suspension of gold payments, followed immediately by a break in sterling to $3.70 in New York and $4.00 in London, compared with par of $4.86. Since then the rate has moved erratically, with a downward tendency, touching in London $3.43 at the lowest. The current rate as we go to press is $3.87. Simultaneously with the suspension of gold payments came the announcement of the Bank of England of an advance in the discount rate to 6 per cent, and open market rates in London were adjusted accordingly.

Effects of Fall in Sterling. Disturbance in Other Centers

Full economic effects of the fall in sterling cannot now be foreseen, but are certain to be far reaching in character.

The most immediate effect has been the spread of the disturbance to other foreign exchanges and money markets. This is partly psychological and partly the result of heavy losses sustained by all lenders having balances in the London market.

Such balances included not only commercial bank funds, but also balances and short term investments of foreign central banks counted by the latter as part of their exchange reserve maintained for the protection of their currency and gold. The following table giving gold holding and foreign exchange balances of principal European central banks indicates the extent to which these banks were committed to the latter. While figures are not available to show the proportion invested in sterling, most, if not all, of these banks may be suspected of having sterling balances, and some are known to have had large balances.

Gold and Foreign Exchange Holdings as of June 30, 1931

(In millions of dollars)

	Gold Holdings	Foreign Exchange
France	2,211	1,027
Italy	281	208
Belgium	199	121
Netherlands	200	92
Switzerland	162	79
Sweden	64	76
Austria	30	62
Czechoslovakia	46	57
Denmark	46	16
Finland	8	22
Greece	6	37
Poland	64	39

Now, with the fall in sterling, central banks in some of the above countries, and in other countries as well, are finding a large proportion of their foreign currency reserve materially reduced. Of course, the situation also works the other way round, and those countries having either long or short term obligations in sterling are finding themselves relieved of a substantial portion of their debt. This is notably true of Germany and other countries of Central Europe where large amounts of British funds have been temporarily uncollectible.

Nevertheless, despite these counterbalancing influences the departure of Great Britain from the gold standard made the disturbance in the Continental financial centers much worse. The immediae effect of the tying up of central and private bank funds in London has been further tightening of credit as shown by central bank discount rate advances in Sweden, Norway, Denmark, Czechoslovakia, Greece, Netherlands and Ireland. These measures were soon followed in Sweden, Denmark and Norway by official announcement of temporary suspension of gold payments. What the result of British developments will be in Austria and Hungary, dependent upon London's financial help, is still difficult to say.

Demands on New York

The development of sudden demands on New York for gold is an outgrowth of the general condition of panic, leading to the conversion by foreigners in the last few days of the month of approximately $280,000,000 of balances into gold, which, except for about $28,000,000 exported, was left ear-marked for foreign account at the Federal Reserve Bank. That further withdrawals of a similar character may take place is considered not unlikely. Fortunately, unlike London, the New York money market is in a strong position to meet such demands as may be put upon it.

The amount of "free" gold in the Federal Reserve Banks (that is, gold in excess of an amount which, combined with eligible commercial paper, will cover Federal Reserve notes 100 per cent and provide for the necessary 35 per cent cash reserve against deposits) amounts to $900,000,000, according to recent figures. In addition to this, the New York member banks probably hold $200,000,000 or more acceptances, which, in the event of continued gold withdrawals, could be sold to the Federal Reserve Bank, and, becoming eligible to replace gold as security behind Federal Reserve notes, would raise the margin of free gold by an equivalent amount. Still further, if the New York banks should rediscount additional eligible paper, of which they hold something like $2,400,000,000 the margin of free gold could be raised an additional $900,000,000 before reducing the Reserve Banks' gold holdings to the legal minimum of 40 per cent against notes and 35 per cent against deposits. In other words, on the basis of the present volume of Federal Reserve credit outstanding, the Reserve Banks could spare something like $2,000,000,000 of gold, and even this does not allow for the further economy of gold that could be effected by recalling gold certificates requiring 100 per cent gold backing from circulation and replacing them with Federal Reserve notes requiring only 40 per cent gold backing. Of course, this is a theoretical maximum which could not be reached under actual conditions, since this figure allows for no further expansion in the domestic demand for Federal Reserve credit, seasonal or otherwise. It does indicate, however, a margin of gold that could be made available for export which seems more than ample to take care of any forseeable demand. In view, however, of these sudden calls upon New York it is interesting to speculate on what the effect might have been had the banking authorities in this country permitted our gold reserve to have become the basis of a credit expansion as large as some of the foreign critics of our banking policies seem to have wished.

Effects on Commodity Prices

The theory that the departure of Great Britain from a gold basis means the inauguration of an era of general commodity price inflation seems to be based on the precedent of the war period when declining exchanges were accompanied by price inflation. The analogy, however, is not a good one. During the war and post-war periods the various European governments whose exchanges were most affected were printing paper money and expanding credit on a huge scale, and this constant dilution of the purchasing media was reflected both in the price tables and in the exchange market. Today, however, the situation is different, in that the cause of difficulty is not so much internal inflation as a breakdown in international confidence which has precipitated a run on important money markets. It is true that when a country throws off the restraints of the gold standard, it makes the way of inflation much easier, but it does not necessarily follow that a country will go that way.

Of course, prices in countries of depreciated exchange are bound to rise in terms of the home currencies, reflecting the increased cost of imported commodities which gradually affects the whole price structure. This, however, has nothing to do with prices in the United States or other countries remaining on a gold basis. While it is true that the large gold stocks in the United States represent a potential source of inflation, this is not a new situation, but a condition which has existed continuously over the past decade. Having large gold stocks and putting them to use are two separate considerations. Our gold stocks might be twice as large as they are today, but if there is no demand for money to call them into use they would no more affect the price level than if they were buried in the ground. For more than a year the Federal Reserve Banks have been doing their best to generate a little inflation in this country by keeping the money market continuously flooded with funds, but without success, for the reason that world conditions have been such that those whose credit rating is good and could borrow have lacked the confidence to do so, while the others cannot find willing lenders. Nor do we think that the events of the past month have changed this situation any.

Effect on Great Britain

It is pointed out that the depreciated pound will enable foreign customers to purchase British goods more cheaply, while at the same time acting as a protective tariff against foreign competition in the home market.

No doubt the price of British goods to foreigners can be lowered temporarily by cheapening the money, but as the drop in exchange begins to be translated into higher prices for foodstuffs and raw materials, what assurance is there that British manufacturers can retain the advantages of lower costs conferred upon them by the depreciated exchange? Moreover, what certainty is there that no wage advances will be required in Great Britain?

Mention has been made of the effect of currency depreciation in lightening the burden of internal debt. It should not be overlooked that it has also decreased the value of incomes available for taxation by an equivalent amount. The country is no gainer by such a transaction.

What the long-time effects of the current events are likely to be on London as a financial

center is impossible to say. Unquestionably, London has a knowledge of and facilities for international financing not possessed anywhere else at the present time. On the other hand, the fact that the New York and Paris markets constitute the only international money centers securely on a gold basis seems certain not to be overlooked. As soon as the present stage of panic ceases the logic of events seems to point to a continuation of the post-war tendency for foreign countries to maintain larger balances at New York. An indication of the tendency for foreign capital to seek investment in this country during these disturbed times is the fact that during the past few months the daily volume of buying and selling orders passing through this institution for foreign account has revealed a continuous excess of purchases over sales of American securities.

The Gold Standard

In permitting sterling exchange to find its own level, the British Government is undoubtedly following an unavoidable policy. While no one can say now at precisely what point stabilization can be effected, all who know the English character and the natural confidence that Englishmen have in their country will feel secure against anything bordering on a complete collapse of the pound. Doubtless some flight of home capital has taken place, but that Englishmen will engage in any wholesale conversion of their property into sterling for transfer out of the country is wholly unlikely.

Recent developments put Great Britain and perhaps Europe generally back where they were before resumption in 1925 which in retrospect seems to have been premature. The post-war developments have been more than the single gold standard was equal to handling. It is preposterous to say that this proves that the single gold standard is impracticable. It is war that is impracticable in a highly organized world. It is probably necessary for Great Britain to suspend until a better state of political order and understanding has been reached. If the world is not advanced far enough in civilization and what Emerson called "facility of association" to use a common monetary standard, it will have to fall back upon more primitive means of exchange, but it will come back to a common standard for the same reason that it evolved one gradually over the centuries, and again groped its way back to the gold standard after the war.

The fact that there has been an undue concentration of gold in some countries to the exclusion of others is not the fault of the gold standard, but is because the world is pursuing policies which have this as their inevitable result. It is folly to suppose that the outcome would be different under any other standard. The necessity for huge unnatural payments on international debts, the innumerable obstructions placed upon international trade, and the political discord and jealousy existing between nations are the real sources of difficulty.

What the world needs is a change of heart, and to learn something of that "facility of association" of which Emerson spoke. The world must begin anew on some common ground—something that gives hope and faith and encouragement for the future, rather than a mere repetition of accusations and suspicions.

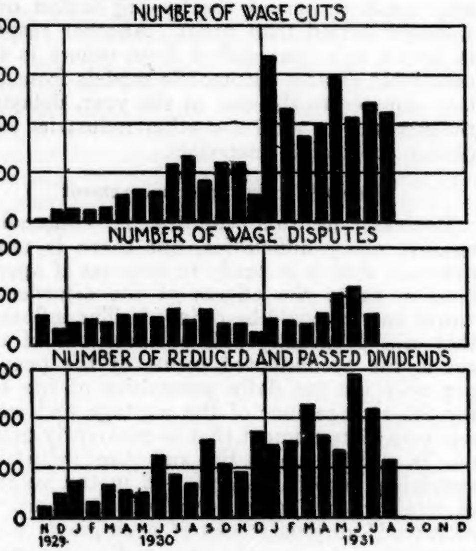
It is for this reason that the harassed people of the world are following eagerly the reports of the visit of Premier Laval and Foreign Minister Briand of France to the German Government in Berlin, and the later contemplated visit of Premier Laval to the United States. If out of these conferences can come a new accord and willingness for mutual cooperation in the solution of problems vital for all, the world will have taken a most important step towards emerging from the economic morass in which it is now floundering.

General Business Conditions

The announcement on September 22 by the United States Steel Corporation that on October 1 it would put into effect wage reductions amounting to 10 per cent, in line with lower living costs, and following previous reductions in salaries and dividends, constituted the outstanding development in domestic business during the month. This move by the principal producer in the principal basic industry, and the possessor by size, management and tradition of a key position in American business, was speedily followed by similar action by other producers in the industry, and by a large number of companies engaged in other lines, which heretofore have hesitated to take this drastic step. Taken with reluctance in view of the social problems involved, the action reduces costs of producing basic industrial materials, and thus marks an important contribution toward industrial recovery. It has been widely accepted as a constructive step by the general public, which had gradually made up its mind that a reduction in steel wages was bound to come, and that the sooner the issue was faced, and uncertainty removed, the better it would be for business.

We have previously commented in these Letters on the tendency of manufacturers to avoid wage cuts, or defer them as long as possible, in the hope that other methods of decreasing costs would meet the situation until business revived. This tendency is illustrated in the accompanying chart showing the number of wage reductions reported to the Department of Labor each month since November, 1929. The largest number reported during

1930 was 133 in August. By the end of the year the idea that the depression was not merely a temporary dip, and required more severe methods of cost reduction, was more widely accepted, and in January, 1931, 335 reductions were reported. In the first eight months of 1931 wage cuts numbered 1,895, and the average reduction reported was about 10 per cent, the same that the Steel Corporation is making.



What has made wage cuts finally necessary is the great decline in the prices of agricultural and mineral products, which has drastically reduced the buying power of those who produce them, and made it impossible for them to purchase products manufactured under predepression wage costs. The exchange of goods has been disrupted. It is entirely erroneous to conceive that readjustments to restore the basis of exchange are not in the ultimate interest of labor as well as everyone else. To the solution of the unemployment problem cost reductions, permitting lower prices that will move goods, will contribute more than any other factor, while the real wages of the people, which are their money wages divided by the prices of the things they buy, cannot suffer from selling them things more cheaply, and putting them back to work. Such will undoubtedly be the ultimate effects of these readjustments.

Few Wage Disputes

In view of the long effort to avoid wage cuts it clearly cannot be said that labor is being made to bear the burden of the depression. That labor is responsive to the necessities of the situation is indicated by the middle section of the chart showing the number of wage disputes beginning in each month, the data again being that of the Department of Labor. A slight increase has occured in recent months, but the rise has been insignificant in comparison with the increase in wage cuts. When contrasted with the 1920-21 depression, not appearing on the chart, the showing is extraordinary. The figures are as follows:

	Number of Wage Disputes
First seven months 1931	498
First seven months 1920	2,246
First seven months 1921	1,790

This comparative freedom from labor controversy is one of the noteworthy characteristics of this depression. It is explainable only by the great advance in employer-employee relationships that has been made during the post war period, and by the reasonable methods employed in making the necessary emergency readjustments. This improved mutual understanding between capital and labor has been a great social asset, keeping the waste of industrial conflict out of a situation already trying enough.

The bottom section of the chart shows the number of dividend omissions and reductions publicly reported, as noted by the New York Times, and including, of course, only corporations of some size. This shows a more regular growth than wage cuts, indicating that the return of stockholders was cut first, a common policy with most companies. Moreover, dividend cuts have been more drastic.

Reduced Costs of Living

The justification for wage reductions in this emergency is not merely in the lowered prices of manufactured goods that they make possible, but in those that have already occurred. A wage reduced 10 per cent from 1929 will now buy more than it would in that year. According to the National Industrial Conference Board's investigations, the cost of living in August was 14.7 per cent lower than in the same month of 1929. The comparison in detail is as follows:

Cost of Living (1923 = 100)

	Aug. 1929	Aug. 1931	Per Cent Change
Food	109.7	81.9	—25.3
Housing	92.0	81.5	—11.4
Clothing	99.5	78.6	—21.0
Fuel and Light	92.3	89.6	— 2.9
Coal	90.0	87.0	— 3.3
Gas and Electricity	96.8	94.8	— 2.1
Sundries	98.4	95.5	— 2.9
All Items	100.7	85.9	—14.7

Food and clothing show the largest declines. In the view of the Board's statisticians these two necessities account for 45 per cent of the family budget, though some investigators would put the proportion still higher for the average wage earner.

In virtually all staple goods of ordinary use price readjustments have gone far. The ex-

tent to which the Great Atlantic and Pacific Tea Co., the largest chain grocery system, has reduced prices of the varied food and household products that it sells can be calculated from its published reports, which include both tonnage and dollar figures. In August, 1929, this system sold 335,628 tons for $75,190,640, an average of $224 per ton; while in the four weeks ended August 29 this year it sold 399,779 tons for $74,410,831, or $186 per ton, a decline of 17.0 per cent.

For department store merchandise no retail price index prior to the first of this year is available. The Fairchild News Service has compiled such an index since that date, and the decline during the eight months ended September 1 was 10.5 per cent, while it is the opinion of the Service that prices are off 20 to 25 per cent from the peak. The greatest declines have occurred in fabrics, in ready-to-wear clothing, and in furniture. This index has shown more steadiness of late, and declined only 0.8 per cent during August. The drop in retail prices for a time was very rapid, and many complaints that quality was sacrificed to make goods cheap have been heard, but something of a revulsion from this view of what constitutes necessary readjustments now appears to be taking place.

Trade and Industrial Conditions

Domestic business during September has shown some of the pickup usually associated with the Fall, but the upturn has lacked vigor and the gains made have been less than normal in extent. In wholesale trade ordering for immediate requirements only has been the rule wherever practicable. The crops, whose movement is one of the stimulants to Fall business, are being marketed slowly, not only because demand is sluggish, but because prices are so low that farmers able to do so are holding part of their product in hope of improvement later. Industrial activity has increased somewhat with the season, but continues characteristically spotted. Operations are at a high rate in certain lines making goods of every-day personal consumption. On the other hand, automobiles, steel, and the heavy machinery and construction industries, which depend largely upon capital expenditures and industrial replacement needs for their markets, are still slow.

While hopes of extensive Autumn improvement do not seem justified in view of the current uncertainties and anxieties, it is likely that to some extent seasonal gains this year have been merely deferred, and may be crowded into the remaining months of the year with helpful effect upon sentiment. The cotton goods business is very much a seasonal one, never lacking in Fall upturn, but up to the last few days of the month buyers had covered forward needs but sparingly. On the first of September both unfilled orders of the cotton mills and their stocks of goods on hand were the lowest since the figures have been compiled. Evidently much business is still ahead, and with stocks small mill activity will respond to it. Offerings of woolens for Spring have been made later than is customary, and in all lines the caution of merchants undoubtedly tends to spread the buying season over a longer period than usual. Another respect in which this year differs from others is the deferment of new automobile models from the late summer to the end of the year, delaying the stimulus to steel and other industries supplying automobile materials.

Forces Working for Improvement

Business in this country is contending against many difficulties, but there is much evidence that it is ready to improve if apprehension as to the effects of the disorder in world finance could be relieved. The influence that will eventually pull business out of the rut is the accumulated wants of the people, not only for the daily necessities of life but for the replacement of the wastage and wear and tear of equipment that is constantly going on. In textiles, shoes, tire and other industries supplying personal wants, and in the volume of retail trade, the upturn is already a matter of record; surplus stocks of such goods were absorbed many months ago, and replacement demand has since been active. In the usual course of events increased activity in these industries is followed within a few months by increased purchases of supplies and machinery, and expansion and replacement projects are carried out, which bring improvement in the heavy industries.

It is evident that American business is now between these two stages, and due to pass into the second as rapidly as the way can be cleared. Replacement of equipment and capital goods, and expansion plans of all kinds, are never as pressing as replacement of articles of every-day consumption, and are deferred as long as confidence is lacking. The foreign situation not only is the chief barrier to confidence, but is a principal cause of domestic difficulties; for it limits trade and depresses the prices of our export commodities, reacting unfavorably upon the cotton and wheat growers, the hog raisers, and the copper producers of this country, among many others. Moreover, it causes losses to investors in foreign securities, which impair their purchasing power, and which have contributed importantly to banking difficulties, and to the decline in our own security markets.

What can individuals do in a situation which seems so completely beyond the power of an

individual to remedy? We have already suggested the answer in noting the decline in the cost of living. Each can put his own affairs in order to fit current conditions, thus not only getting ready for the upturn, but contributing toward it. The natural remedy for a disordered equilibrium is to work out a new one, and adjustments to that end are going forward all the time. Debts have been paid, and savings accumulated. Great gains have been made in the efficiency of individual businesses. The officers of this Bank in the course of their duties come in touch with business men in all lines who testify that they have weeded out wastes and reduced costs to a point which two years ago would have appeared out of question. The whole business machine is being tightened up during this period, and put into better working order. This is a necessary precedent to recovery; and while its benefits cannot be fully realized until restoration of equilibrium in other directions is accomplished it is the most effective means by which individuals may combat the depression.

Agricultural Conditions

The heading of the September survey of the farm situation issued by the Department of Agriculture is "A Lean Year in Spite of Fair Crops." The Department's index number of prices of farm products dropped from 79 per cent of the 1909-14 average in July to 75 per cent in August, which compares with 108 a year ago. Corresponding figures of farm purchasing power, the ratio of prices received to prices paid, are 61 in July, 59 in August, and 74 a year ago. During September the movement of prices has been more nearly sidewise, with the exception of cotton and hogs, two important sources of income, which dropped to new lows.

The most favorable factor in the situation, and one of great importance in the general business outlook, is the steadiness of wheat prices. Wheat is a very important commodity in this country, not only as a source of income itself, but because its fluctuations affect prices of the other grains and greatly influence the sentiment of the farming communities and those who sell to them. Evidence that the world wheat position is turning for the better has been clearer in recent weeks. Estimates of European crops, particularly those of Germany and France, have been reduced somewhat. The rye crop of 13 European countries is 132,000,000 bushels, or 16 per cent, less than last year. Russian wheat exports have been heavy, and are estimated at 30,000,000 bushels up to September 12 compared with 10,000,000 in the same period last year. However, this is winter wheat from the Ukraine, where the crop was good; offerings of spring wheat are lacking, and all reports agree that outside of the Ukraine the crop was short and that the export movement is likely to fall off. Estimates of drastic reduction in acreage in the Southern Hemisphere are confirmed, and altogether the falling off in new crops seems certain to be greater than the increase in the carryover into this season, indicating that total world wheat supplies may be 200,000,000 bushels smaller than a year ago. In the Southwest soil conditions have not been favorable for the preparation of winter wheat acreage, and the Department of Agriculture reports that farmers intend to plant 12 per cent less, while the yield per acre is unlikely to equal this year's exceptional outturn, which was the highest since 1914.

Both American and Canadian wheat is moving steadily into export. The Farm Board has sold 15,000,000 bushels to China and 7,500,000 to Germany on long term credits, and may sell more, and has swapped 25,000,000 bushels with Brazil for coffee. There is much argument over the Board's policies, as always when the government engages in business. At least it will make no more purchases. Mr. Carl Williams, the Vice Chairman of the Board, packed the history of the Farm Board era into two brief statements when he announced on August 31 that—

> The Board has discovered, and hopes the American people have discovered, that continued purchases in the face of over-production is not the remedy for the situation. * * * *
>
> Cotton stocks have accumulated over a period of four years, wheat stocks over six years. In the face of this condition, we think the Board should make no more purchases.

Low prices of feed grains are helping live stock feeders and dairymen to maintain their position during the depression. The prices of cattle and hogs, though low, still permit feeding operations at the present levels of the grains. During the Spring, when butter prices declined severely, feeding margins for butter producers were wiped out, but in the summer the output was sharply reduced by poor pasture conditions, while consumption has been ahead of last year; and prices have climbed since August 1 from 25¼ to 32½ cents for creamery extra butter at New York, while feed grains have gone down.

No improvement has occurred in the cotton situation, either in the price or in the statistics. The government crop estimate on September 1 added 101,000 bales to the previous month's figure, making the crop 15,685,000 bales, and the total supply of American cotton 24,600,000 bales, including the world carryover of 8,919,000.

An Import Balance of Trade

The effects of the disorder in world finance fall with great force upon the cotton exporters of this country. To the end of July cotton

exports ran steadily ahead of 1930, but during August they dropped sharply, and between August 1 and September 25 totaled only 582,000 bales compared with 1,043,000 a year ago. The decline was entirely due to smaller takings by Europe. Only 21,061 bales were shipped to Great Britain, against 141,298 in 1930; 22,820 to France, against 169,313; and 94,685 to Germany, which compares with 363,943.

Decreased foreign purchases of our merchandise produced an unfavorable trade balance of $5,000,000 for this country in August, the first since May, 1929, and with that exception the first since 1926. Exports declined from $294,000,000 a year ago to $162,000,000, a drop of 45 per cent, while imports fell only 24 per cent, from $218,000,000 to $167,000,000. This illustrates a tendency of the times, which is that the export trade of creditor countries is restricted by the necessity of debtor countries to balance their position, which they do by cutting down their purchases and increasing their sales abroad. The former is carried to the point of putting restrictions of all sorts on imports, while the latter entails almost a forced liquidation; and both influences weigh heavily upon the commodity markets, and depress prices.

Money and Banking

We have already referred to the unprecedented conversion of foreign funds employed in this country into gold, which has been the outstanding feature of the money markets during the month. The net amount placed under earmark totaled, up to the last day of the month, $257,600,000, of which $251,100,000 was done subsequent to the cessation of gold payments by Great Britain, and undoubtedly had its motives in the disturbance created in world finance by that momentous event. In addition, about $28,000,000 of gold was exported.

Payment for the gold was made partly out of foreign balances carried at the Reserve Bank and partly by action of the Reserve Banks in taking into their own portfolios bills previously held for foreign account, neither transaction affecting the money market. For the balance, foreign holders of bills sold them to the market, which in turn replenished itself by passing them on to the Reserve Bank. Thus, the effect of these operations, plus increased member bank rediscounting to satisfy domestic demands for currency, was to substantially increase the volume of Federal Reserve credit outstanding, without diminishing the volume of funds at the disposal of the market. Nevertheless, despite the continuance of ample supplies of funds, the psychological reaction to announcement of large gold losses was to cause some advance in money rates.

From the level of 1 per cent bid 7/8 asked for bills up to 90 days maturity, which had prevailed since May 19, acceptance rates were raised 1/8 on September 22, and another 1/4 on the 24th, to 1 3/8 bid, 1 1/4 asked. The rate at which the New York Federal Reserve Bank will buy bills was raised on the 25th to 1 1/8 per cent. Under normal circumstances this rate is kept accurately in line with the open market, but in this case it was not raised until three days after the first advance by dealers. This, coupled with the 1/8 of 1 per cent differential under the market still maintained, constitutes notice that the Federal Reserve System stands ready to protect the market against undue disturbance in rates in consequence of these sudden gold withdrawals.

The rate of 1 1/2 per cent for demand loans on Stock Exchange collateral, that has been in effect throughout this year, except for a very few days, has not been affected by this tightening of the situation, but time loans are firmer.

Rise in Currency Circulation

The continued rise of currency in circulation brought the total on September 23 up to $5,164,000,000, a higher figure than was reached at any reporting date during the boom period, even at Christmas time, when a seasonal increase of several hundred millions always occurs. This figure represents a nearly uninterrupted increase of $384,000,000 since the end of July, and is $728,000,000 larger than at the same date last year.

This abnormal rise of circulation is due to banking troubles and to apprehensions of the public concerning the safety of its money in the banks. Such a condition and state of mind has usually developed in this country at some time or other during depressions, and is a price that is paid for having the system of unit banking to which the country is devoted. Individually, hoarding of currency is an expression of the instinct of self-protection, always strong in an individual who does not know what others are doing, and who is surrounded by disturbing rumors and circumstances. Collectively, it is a cause of trouble, and adds to the severity of troubles caused by other conditions.

Under the Federal Reserve Act the country has a system of currency supply, unexcelled in its elasticity, through which the foregoing demands have been met as a routine matter by the release of additional Reserve Bank credit as necessary. However, such an abnormal rise, and the conditions that caused it, cannot have been without effect upon the situation in many ways. They have been a prime cause of weakness in the bond market during the past two months, banks having sold bonds and switched into the highest grades in the in-

terest of adding to their liquidity. The reporting member banks during the seven weeks ended September 16 reduced their investments in other than government securities by $73,000,000; but increased them $43,000,000 in the following week. If figures were available for non-member banks, which when facing a situation of this kind may be under greater necessity to sell bonds because they lack direct access to Reserve Bank credit, a very marked decline would doubtless be shown. Of the 932 bank suspensions reported this year, to the end of August, 203 were of member banks having deposits of $281,980,000; while 729 were of non-member banks having deposits of $416,836,000.

Banking Policies in Depression

One of the striking aspects of the present situation is that while people on one hand demonstrate a lack of confidence in banks by withdrawing deposits and hoarding currency, on the other they frequently allege that lack of courage or excess of caution on the part of bankers in making loans is one of the reasons why business is slow to climb out of depression. Nearly everyone seems to have a favorite story of a supposedly worthy borrower who is unable to obtain a loan for a desirable purpose, and the projects which it is said bankers ought to undertake range from loans of a few hundred dollars for individuals up to hundreds of millions for financing schemes to revive world trade.

If there is caution in the situation, where does the root of it lie? The answer is, of course, that what has caused bankers to consider liquidity the first essential in their position, and to govern their affairs accordingly, has been the rising fears of the people themselves. Banks' money is not their own, and the paramount duty of any banker is to be able to repay his depositors on their demand. In order to do this he is required by law to keep primary reserves, and by prudence to keep secondary reserves, which are made up of securities and bills that are salable or can be borrowed upon in case of need, and of loans repayable on demand. With respect to his time loans, prudence further requires that a certain proportion of them come within the secondary reserve, by fulfilling the requirements which make the paper eligible for rediscount by the Federal Reserve Banks.

Of course the amount and character of the secondary reserve necessary for a sound position vary according as times and confidence are normal, or strained. In normal times, a banker can count upon a merely normal demand for repayment of deposits. In abnormal times, with sound banks experiencing runs and the people readily swayed by rumors or untoward events, he can count upon nothing, and must be prepared for the worst. To be assured of his ability to meet any possible demands he must have a larger percentage of his loans of such quality that he can borrow upon the paper. More of them must be self-liquidating loans covering specific industrial or commercial transactions; and collateral loans must be not only good, but liquid, in that the collateral can be sold readily in an open market.

Despite the loose talk upon the subject, there is no evidence whatever that loans of unquestioned liquidity are hard to obtain. On the contrary, it is borrowers who can meet the specifications who are scarce, since trade, which creates demand for such credits, is at a low ebb. It is doubtless true that the yardstick which bankers apply to applications for commercial loans is now a more rigid one than in times of less uncertainty and more generally profitable business. But the propriety of this does not seem open to question. Moreover, the standards applied to collateral loans must vary with the degree of confidence felt by the people in the business situation and in their investments. The past two months have been trying ones in the security markets, and values at times have receded rapidly. Demands by depositors have compelled banks to sell bonds, and alarmed individuals have sold their own holdings. This has depressed market prices in many cases without reference to intrinsic values, and has reduced the current worth of investments of all banks, this being a prime cause of the conservatism in making loans that is complained of.

Should the people, as borrowers, feel aggrieved at what they term the lack of courage of bankers under such conditions? Or should they, as depositors, feel satisfaction that bankers are guarding their ability to repay their deposits when they want them? Whatever others may think about it, bankers can have no choice, their obligations being determined by the law. The situation is not an agreeable one. It is unfortunately one of the ways in which the public's lack of confidence in banks and in investments reacts upon itself.

Paying Depositors of Closed Banks

In communities where bank closings have occurred, efforts of solvent banks to do all they can to alleviate distress caused to depositors are generally evident. The New York City banks, which last winter made loans enabling payment to depositors in the failed Bank of United States of 50 per cent of their deposits, without waiting for liquidation, have adopted a similar policy with reference to five smaller banks recently closed. Acting as agent for a group of twenty-two banks and banking

firms, the Manufacturers Trust Company has contracted with the State Superintendent of Banks to purchase the assets of these banks, and upon approval by the courts will at once make available to depositors 50 per cent of their claims. It will proceed to liquidate the banks and pay further amounts to depositors as funds may become available in each case.

The benefits of such action to those whose money is tied up may be judged by the fact that the first dividend from the liquidation of the Bank of United States, totaling 30 per cent, has but recently been declared, whereas the depositors have had available 50 per cent of their funds almost from the time of the failure last December.

The Bond Market

The bond market during September has suffered severely under the disturbance caused by the foreign situation, the continued depression of business, and from such manifestations of lack of confidence within this country as appear in the hoarding of currency and banking difficulties generally. In these circumstances, far from being willing to undertake fresh risks, capital has been concerned for the safety of the situations in which it is already involved; and the tendency to withdraw from such situations has been carried to an extreme degree during the month, forcing bond prices down to the lowest point of the depression. The fall has embraced all groups and all ratings, even bonds of the highest grade which had held steady during the August decline. The decline in United States Government issues has been a striking feature of the situation, and is shown by the following table:

Prices of U. S. Government Bonds

	Sept. 1, 1931 (Closing)	Sept. 28, 1931 (Closing)	Decline
Liberty 3½s, 1932-47	102.8	101.18	.22
" 1st conv. 4¼s, 1932-47	102.27	102.00	.27
" 4th 4¼s, 1933-38	104.27	103.12	1.15
Treasury, 4¼s, 1947-52	112.15	108.31	3.16
" 4s, 1944-54	108.6	104.27	3.11
" 3¾s, 1946-56	106.7	103.00	3.7
" 3⅜s, 1943-47	102.26	100.2	2.24
" 3⅜s, 1941-43	102.22	100.00	2.22
" 3⅛s, 1946-49	101.10	99.2	2.8
" 3s, 1951-55	100 *	97.28	2.4

* Issued at par Sept. 15.
Note: Quotations after decimal represent thirty-seconds of a point.

We discuss subsequently in this Letter the financial position of the Government, but it is not amiss to point out here that the decline is evidence that despite the unquestioned pre-eminence of U. S. Governments among the investment securities of the world, their price is inevitably affected by the law of supply and demand. Even in a period when safety is the first consideration of investors, the issuance of constantly increasing amounts of securities necessitated by an unbalanced budget, in a market narrowed by the general reduction in purchasing power, cannot be accomplished without depressing effects upon the prices of the outstanding issues. Fear that issues will be excessive in the future is as potent a factor in the situation as their actual issuance. These matters may well be considered by those who are proposing vast schemes for the alleviation of the depression, all looking toward the Treasury for their funds.

On September 15 a new long-term Treasury issue was brought out, consisting of $800,000,000 in 20-24 year bonds bearing a 3 per cent coupon, the lowest carried by any post-war long-term offering. Subscriptions totalling $940,559,550 were received for the bonds and a total of $803,249,000 was allotted. The new bonds have sold continuously below par since they were first traded in.

The decline in prices of domestic corporation and foreign bonds has raised their average yields to the highest point of the depression period. The following table presents yields of 160 such bonds grouped according to their rating by Moody's Investors Service, as of September 23:

Average Bond Yields

Rating	Forty Railroad	Forty Utility	Forty Industrial	Forty Foreign	160 Bonds
Aaa	4.83	4.31	4.77	5.90	4.95
Aa	5.67	4.69	5.17	7.22	5.69
A	6.99	5.23	7.26	15.17	8.66
Baa	8.84	7.28	9.03	18.95	11.03
Average	6.58	5.38	6.56	11.81	7.58

These are all bonds which, under the ruling made some time ago by the Comptroller of the Currency, and recently made public, banks are allowed to carry at their book value (purchase price) as long as regular interest payments are received. This policy, in the view of the Comptroller's department, is a "sound and reasonable" one because under present conditions officials believe that "some bonds have shown a depreciation not at all justified by the position of the security backing them."

With respect to the highest grade bonds and to many of the others this undoubtedly is the case. In the second grade corporate bonds, unsatisfactory earnings and prospects continue the disturbing factor, again emphasizing the tendency of such bonds to follow the course of the stock market and of business.

Foreign issues as a group have been weak, and even the highest grade European dollar bonds lost ground under the disturbing effects of the British crisis. Bonds of the Scandinavian countries, which hitherto had been stable in price, declined severely, although payable in dollars, their proceeds thus not being af-

fected by the decline in the exchange value of the currencies of the various countries. The 5½s of Great Britain declined drastically to 92, which compares with the year's high of 108¾, but recovered several points as soon as time permitted a more reasoned view of the situation, and upon the assurance of Mr. Snowden that they would be paid in gold if necessary. Japanese bonds, which likewise had been stable, also declined.

Unquestionably there has been a good deal of hysteria in the bond market. The participation of many sound bonds in the September decline was due not to lessened intrinsic worth, but to forced or frightened selling. Sound investment positions are in many cases being unnecessarily sacrificed not through any serious doubt as to the security of the bonds, but for fear the price will go lower. It is evident that such selling involves the abandonment of investment principles for those of speculation, and while we do not venture to predict when the selling movement will end, we do not doubt that the outcome will be that the securities sold by frightened holders will be found in the hands of far-sighted investors who are laying the foundation of substantial future gains.

Meanwhile the situation is a trying one, causing difficulties as well as reflecting them. It is undoubtedly the greatest present drag upon domestic business recovery, making it extremely difficult for those who have projects in hand to obtain capital for carrying them out, and reacting upon the banks in the manner previously described in this Letter.

Governmental Finance

During the near future the Government will be required to determine its policy on the question of balancing the national budget. Expenditures for the fiscal year ended June 30, 1931 exceeded receipts by $903,000,000, the first time that a deficit has occurred since the year 1919, when there was a large carryover of war expenses. In approximately one-quarter of the current fiscal year beginning July 1, 1931 and extending through September 25, the deficit was $374,000,000.

It is probable that the general public has given little attention to the course of Governmental finance during recent years for the reasons that less than 2,500,000 people out of the entire population pay any Federal income tax and that the cycle of prosperity which culminated in 1929 provided ample funds to allow successive reductions in rates of taxation and yet to effect a steady reduction in the national debt. Since 1927 there has been a constantly increasing total of expenditures. With the severe decline in business activity that is now in its third year, combined with losses from the collapse of security prices, omission of dividends, etc., the income taxes paid by corporations and individuals have greatly declined, while the level of Governmental expenditures has continued to grow.

Decline in 1931 Receipts

The decline in receipts that occurred in the last fiscal year, ended June 30, 1931, is shown by the following summary classified according to the principal sources:

Governmental Receipts 1930-31
(In millions of dollars)

	1930	1931	Change
Income tax—corporation	$1,263	$1,026	$—237
Income tax—individual	1,147	834	—313
Customs receipts	587	378	—209
Misc. internal revenue..........	628	569	— 59
Misc. receipts	552	509	— 43
Total ordinary receipts....	$4,178	$3,317	$—861

Income taxes paid by corporations and individuals supply more than half of all receipts, and the substantial decline this year reflected the shrinkage that occurred in corporate and individual income. The first half of the Government's 1931 fiscal year, from July 1 to December 31, 1930, included the third and fourth quarterly payments of taxes on 1929 income, which was at peak level, but in the second half of the fiscal year, from January 1 to June 30, 1931, taxes were on the reduced 1930 incomes, and those paid by corporations declined by 38 per cent and by individuals 49 per cent. Because of income taxes lagging a year behind income, even a return to prosperous conditions in 1932 would not be reflected in materially increased Government revenues for a year and one-half from the present time.

Increase in Expenditures

In the face of an estimated decline in Government receipts last year, the actual extent of which greatly exceeded expectations because of the severity of the depression, the budget of expenditures was increased $21,000,000 over the record peace time budget of the previous year and reached $4,015,000,000.

This was $180,000,000 more than estimated receipts, and would have been bad enough, but actual expenditures ran $205,000,000 in excess of the budget estimates. The principal changes in expenditure are given in the preliminary report of the Treasury as follows:

Governmental Expenditures 1930-31
(In millions of dollars)

Principal Increases	1930	1931	Change
Treasury Department	$193	$204	$+ 11
War Department	454	479	+ 25
Dept. of Agriculture	178	297	+119
Veterans' Administration	447	500	+ 53
Postal Deficiency	92	146	+ 54
Federal Farm Board	150	191	+ 41
Adjusted Service Cert. Fund....	112	224	+112

Governmental Expenditures 1930-31
(In millions of dollars)

Principal Decreases	1930	1931	Change
Navy Department	374	354	— 20
Interest on Public Debt	659	611	— 48
Refunds of Taxes	134	70	— 64
Public Debt Retirements	554	440	—114

Increases due chiefly to following reasons: War Department, cost of construction activities in connection with rivers and harbors, flood control, the Army housing program and increased outlay for the Air Corps; Department of Agriculture, largely additional outlays for Federal aid highway construction and for emergency relief in drought-stricken areas; Veterans' Bureau, liberalized provisions for military and naval compensation to war veterans; Federal Farm Board, additional loans under agricultural marketing act; Adjusted Service Certificate Fund, advance appropriation in 1931 that would ordinarily have been made in 1932.

Decrease in Navy Department expenditure due chiefly to a reduction in armaments.

Fiscal Policy

The principles of Government finance in the United States do not differ from those in other countries. America is a country of great wealth but also the deficits in our Governmental budget are very great.

There are three ways in which a deficit may be met: a decrease of expenditures, an increase of revenue and an increase of public debt. With a possible deficit as large as is now indicated, cutting of expenditures alone cannot bring the budget into balance without an abandonment of Government services which are essential to the public welfare. Something, however, can be done in reducing materially next year's appropriations below this year's and certainly no new expenditures should be considered. An increase of taxes is indicated, but new revenue during the period of depression may not be found sufficient, with a cut in expenditures, completely to balance the budget. Some additional borrowing must be undertaken.

It is one thing, however, for a Government to borrow money to bridge over a depression after it has made all possible efforts to increase its receipts and diminish its expenditures. It is quite another thing for a Government to make no real effort to balance its budget but to rely entirely upon its credit for financing its normal current operations. A Government, like an individual, must in the long run live within its income. The continual offering of new Government bonds takes funds out of the investment market which should be available for financing industry when production improves. The fact that the supply of Government bonds may be expected to continue to increase lowers their price and increases the cost of Government financing. Of much greater importance, however, is the market decline of existing securities in the hands of the investor, which must come about if the public feels that the Government is living upon an unsound basis of of finance. Not only will many innocent holders of Government bonds sustain losses, but the Treasury will experience a substantial increase in interest cost through the higher yields at which refunding and new issues will have to be offered.

Investors are closely watching the formulation of the program for the next Congress, and the day-to-day bond market will reflect their confidence in the ability of the Government to check the growing deficit of the Treasury and to withstand the demands for the host of proposed additional expenditures running into many billions of dollars.

Controlled vs. Free Economy

In the current flood of comment upon the nature and causes of the depression a prominent place is occupied by statements to the effect that the world has been allowed to drift into chaos, through lack of plan or direction in the existing economic system. These statements describe the system as a "hodge podge" or a "hit or miss" economy, or in other terms suggestive of inherent instability and confusion; and they usually set up for purposes of contrast a hypothetical picture of a more stable and ordered world, and demand that some method of planning or controlling the business of the country be put into effect in order to bring their ideal to realization.

The issue thus raised is a very serious one and is entitled to the most open-minded consideration that everyone can give to it. The merits of planning in the abstract are indisputable. The term signifies merely the exercise of such foresight and ordered effort as people are capable of; and there is doubtless much room for the extension of the kind of planning in the interest of stability that is always being done in the United States, by individuals and corporations, either alone or in voluntary association with others facing common problems. The industries continually experiment with and employ market analyses, consumption forecasts and production budgets, and are certain to extend their use as rapidly as reliable methods, worth their cost, may be perfected. Trade associations promote cooperation in such activities. With respect to general economic policies, there are numerous well qualified organizations, both public and private, which disseminate carefully prepared information regarding business conditions; and it may be said correctly that in some degree everybody plans, though with widely varying results.

A program for the extension of such planning has been presented during the current month by Mr. Gerard Swope, president of the General Electric Company, who is one of the

country's industrial leaders. Mr. Swope's proposal is that industrial and commercial companies having fifty or more employes and doing an interstate business should be gathered into trade associations—one for each industry—under Federal supervision. The effort of these associations would be to stabilize business and employment, and their functions would be to distribute information on volume of business, inventories, standardization of products and stabilization of prices; to outline trade practices, business ethics and methods of standard accounting and cost practice; and in general to promote the co-ordination of production and consumption "on a broader and more intelligent basis." The setting up of reserves against unemployment, disability and old age is another feature of the program.

Mr. Swope's proposal is evidence of the desire of business leaders to improve the situation, and he has done a constructive thing in setting up a definite program by which the industries can judge whether they want overhead planning and whether its benefits would balance its costs.

Difficulties in Way of Planning

It is evident that doubts concerning planning proposals will arise in proportion to the degree of control or overhead authority that they include. Many critics of the present system insist that, in the complex relationships of business, the best of planning for separate industries cannot be effective without national co-ordination. They demand an overhead authority or super-council to control all business, regulating the development of the country, and alloting production quotas to the various industries, all on the plea that goods would be brought on the market in right proportions to exchange for one another without leaving a surplus of unused capital and labor, thereby avoiding depressions.

We wonder whether those who are attracted by the idea of a world kept in order by such a central overhead authority fully realize all the implications of the proposal. What evidence is there that the methods of statistical analysis and forecast have been sufficiently developed to justify setting up a central body to act upon them? Who would sit upon super-councils to plan and direct business? Who could vouch for the wisdom of the councillors, or make the experts agree? If they were infinitely wise, what assurance is there that in a democratic society they would be left free of political influence or control? If their function were advisory, and their plans dependent for execution upon voluntary cooperation, who can say with confidence that their advice would be followed?

These are formidable questions. Moreover, considering the limitations of forecasting, how can adjustment of production to consumption be even theoretically possible unless consumption likewise is controlled in detail, so that it can be accurately measured? What quota system could guage the shifting desires of the American people, and who would suggest rationing them to make the consumption fit the quota?

It is evident that effective national planning would involve controls and restrictions upon individual freedom and enterprise. Its suitability for any country therefore depends greatly upon the value that the people attach to their liberties, and the tenacity with which they hold to them even to the extent of disobeying prohibitive laws. It is not sufficient to argue on behalf of national planning for the United States that it will work in any other country, or in an imaginary state. If there is any merit in the proposal it must work in the sort of political and social organization that the American people, who are the arbiters of the matter, elect to live in.

Nothing in their history or traditions supports for a moment the view that the American people would want a perfectly ordered and stable world at the price they would have to pay for it. Their facility in co-operation will increase, but as individuals they insist on being free. The more complete and compulsory the regimentation provided in the various planning schemes advanced for this country, the more visionary they are, and the less likely ever to win support. On the other hand, the less complete the program, and the less supported by legal compulsion, the less effective national planning would be. This is the dilemma upon which the whole argument may be said to break down.

The System of Individual Effort

The system upon which it is urged that overhead planning should be imposed is a system of individual effort, in which each person is free to engage in any honest work within his capacities. Anyone who originates a new product, or an idea for a new service, is free to develop it, to obtain capital for promoting it, and to engage in the business of selling it. Anyone who can improve upon an old method of producing anything, cheapening the cost of the product and making it available to more people, is free to enter into competition with existing producers. The system is one of rivalries and constant change, in which miscalculations are made and confusion occurs, but it has achieved a phenomenally rapid economic progress, raising the standard of living of everyone, and has created the reserves

which are enabling the people of the country, helping one another, to withstand these hard times.

Under this system the agencies tending to maintain the equilibrium are prices and profits, which rise when there is too little of anything, and decline when there is too much, and hence act as traffic policemen directing the flow of capital and labor into and out of various enterprises. The agencies tending to disrupt the equilibrium include wars; political and social disturbances; changes in monetary systems; natural calamities such as drought; interference with the flexible adjustment of prices and the free movement of goods and capital; the defects of human nature, which lead men into extremes of exhilaration and depression, or debt-making and debt-paying, and into irrational economic behavior; and even progress itself, which always disturbs someone and requires constant readjustment to new methods and new ideas.

Under the system of individual effort, when equilibrium is disturbed the readjustments that become necessary to restore it are accomplished by individuals seeking to make profits or to avert losses. They shift from one business to another, or they reduce costs to stay in their own business, and since shifting is frequently a painful process the incentive to reduce costs is great. In the long run the burdens of readjustment fall upon the highest-cost and least efficient producers, and if progress is to continue that is where the burdens belong.

Between this process of piecemeal readjustments by individuals of their own affairs and the overhead allocation of output through quota systems there is an impassable gulf of economic difference. It is idle to suppose that planning could avoid these readjustments, but it is very much to the point to ask upon whom it would lay the burdens?

In the automobile industry there are a score of makers of passenger cars, with more capacity than will be needed during the next several years. But in any year it is certain that some will offer cars of greater merit or more acceptable to the public at the price asked than others, and if the public is to be prevented by quota systems from buying from these producers, of what value is enterprise? Perhaps it will be said that planning would eliminate overcapacity, so that all could keep busy. To a certain extent this would be desirable, but how could those to be eliminated be chosen safely except through free competition? Moreover, too rigid adjustment of capacity to market would eliminate two safeguards which the present system gives to the public, one the ability to expand output to meet unforeseen demands, and the other the competition which is the incentive to cost reduction and to improvement in the product.

Experimentation and Pioneering

Much progress under the system of free enterprise is derived from experimentation. New methods save labor and release it from the old industries, to be absorbed by new industries. The old goods become cheaper, releasing purchasing power for the new, with the result that everyone obtains more goods for the same expenditure, and the standard of welfare is raised. The history of the past hundred years has demonstrated the truth of this many times over.

The absorption of labor from the old industries into the new does not always occur immediately, causing technological unemployment, a problem much stressed by the same persons who advocate overhead control of business. But obviously the way to solve technological unemployment is to encourage experimentation and enterprise by preserving the inducements which stimulate them, instead of subjecting them to the restraints of quotas or licensing systems.

It might be said on behalf of planning that waste of capital and labor in pioneering could be avoided by regulating the development of new industries under overhead authority. But how are those entitled to survive to be selected without the trial of competition? During the lifetime of the automobile industry several hundred of those who produced cars at one time or another have succumbed to competition, but who could have picked the winners at the start? Furthermore, how much of the industry's progress would never have been achieved if those doomed to fail had been kept from beginning business, on the ground that the industry must be developed in an orderly and balanced manner?

The foregoing are all ways in which overhead planning, if effective, would be restrictive of progress, a price far too dear to pay for anything it would be likely to return in the way of better equilibrium. The truth is that the whole concept is a deadening one, not in tune with the principles which pervade the modern system of education and through it the whole field of human affairs, and which may be described as leading to the fullest possible release of whatever creative enterprise and powers each individual may possess.

Planning for Agriculture

In one branch of American business much overhead planning of the advisory kind is already done and its results can be examined. We refer to agriculture, of which cotton affords an example. The Department of Agriculture spends millions each year not only in helping

cotton growers improve their methods, but in advising them as to their plans and in spreading information as to market and economic conditions all over the world. The Farm Board is free with advice and has vigorously supported compaigns for acreage reduction and diversification, to which the aid of the press and of bankers has been freely given. Powerful cooperative marketing organizations are in existence, financed in part by Treasury funds, and their admitted function is to assist the formulation of production programs as well as to market cotton. All three of these groups work in harmony and should and doubtless do exert a great influence on the trends within the cotton growing industry. It is fair to ask what planning system could be set up that might accomplish more, or that could strive more effectively to obtain a production that would balance with demand.

The Farm Board has an able economic staff of its own and the excellent service of the Department of Agriculture to call upon, and its forecasting was probably as good as any other planning board would have done at the time, hindsight not counting. But the forecasts upon which its plans were based in both 1929 and 1930 proved hopelessly mistaken. In the fall of 1929 it grossly over-estimated the prospective consumption of American cotton and thus fell into the error of attempting to peg the price at an impossible level. In 1930 it made essentially the same mistake. In both 1930 and 1931 it advised the farmer to cut cotton acreage, a sound plan in the existing conditions. But the response was disappointing. In 1930 there was virtually no reduction, and this year a 10 per cent cut instead of the 25 per cent recommended. Furthermore, the advice conveyed nothing not expressed far more effectively in the price which, being below the cost of production, forcefully put the farmer on notice as to the situation, and undoubtedly was the true cause of the moderate curtailment effected.

As an example of planning, this record includes inaccurate forecasting of consumption, inability to persuade growers to follow recommendations as to acreage, and finally the refusal of nature to acquiesce in the plan; for favorable weather this year has produced an exceptional crop, and the Farm Board era ends amid the largest over-supply of cotton on record.

The Sound Kind of Planning

What except false hope can there be for the farmer in such planning? The outcome of three years of effort is a price situation disastrous to the growers. The truly sound kind of farm planning is that for which the Federal and State Departments of Agriculture were set up. It centers on the individual farmer, assisting him to make the most efficient use of his capacities, his equipment, his land and his location with respect to markets, so that he can grow a better quality of cotton at a lower cost, or grow something else better than he can grow cotton, thus lifting himself out of the marginal producer class. All the efforts to improve the situation of the cotton grower. will be unavailing unless continuing progress is made in that fundamental requirement.

A necessary outcome of the present condition is that fewer persons and acres can be employed in growing cotton next year, and perhaps in other years. How would national planning meet this problem? Acreage reduction alone is no permanent solution of farm difficulties, the method being all-important. The kind of acreage reduction needed is the kind that increasing per acre yields makes possible, cheapening the product so that the world may buy more of it, and of other things. Would planned economy compel the inefficient and high cost grower, the marginal or submarginal producer, to bear the pangs of readjustment? That is what will be accomplished in the long run by leaving the industry to be regulated by the price. Or would the easier method of a horizontal reduction be followed, penalizing the consumer and perpetuating instead of solving the problems of agriculture? If it is proposed to adjust planning to differing individual circumstances, is any agency or method better than that of the present agricultural services needed, or possible?

With many of the objectives advanced for agriculture by planning programs, we are in full agreement. Reforestation of wasted and poor lands is desirable, and a proper sphere for governmental action, though private initiative might undertake the task if government tax policies took a realistic view of the situation. But there is nothing in this or similar proposals that existing government agencies could not perform.

No Analogy in War or Russian Experience

It is common practice to point either to the experience of the United States under the War Industries Board during the World War, or to the Russian experiment today, as analogies justifying national planning for this country. These analogies in reality do not exist.

The problem of the war was to convert industries with all possible speed from a peacetime to a wartime basis, and to give precedence to war needs over all other activities, a situation obviously requiring an overhead authority to determine and enforce the priorities. The people were animated by the war spirit, submitted themselves to the control enforced, accepted its errors as excusable and

its wastes as unavoidable in the emergency, and gave cheerful co-operation to measures that in peace they would not have suffered. Mr. Bernard M. Baruch, who was the chairman of the War Industries Board, is in a position well to understand the difference between the problems of war and of peace time, and is under no illusion that the experience of war is applicable to other than war conditions. In a recent statement before the War Policies Commission he said:

The thought is often expressed "If we can solve our industrial problems in war by this method why can't we use these same methods in peace." The answer is: Incentives in peace are individual freedom and the hope of reward. Incentives in war are love of country, idealism and defense against a common danger. President Wilson struck the keynote of the whole matter when he said: "The highest and best form of efficiency is the spontaneous cooperation of a free people."

Russia's endeavor is essentially similar. Hers is likewise an emergency effort, its main objective being to speed the creation of means of production at an abnormally rapid rate. The effort is possible only because the government rigorously limits the current consumption of the people through a rationing system, and exercises a monopoly on the resulting savings, which it applies to its gigantic construction projects. As to the applicability of such methods to the United States the testimony of Professor Charles A. Beard, formerly of Columbia University, and an advocate of national planning, will not be considered "stand pat." In the Forum magazine for July he said:

If capitalism were cursed with all the evils ascribed to it by Communists (and it has plenty to its credit), still the American people, on a fair and free count, would vote one hundred to one for keeping it rather than enslave themselves to the kind of political and economic despotism regnant in the land of the former Tsars.

There are many questions and uncertainties involved in the Russian experiment, which space forbids touching on here. Omitting all other considerations, even if the experiment achieves its immediate object it will not have solved, any more than our own wartime success solved, the problem of keeping world business, highly developed and highly interdependent, in the equilibrium by which alone it can function harmoniously. The best way to maintain the equilibrium is to keep the world politically in order, and to leave the governor of the machine, which is prices, free of artificial control. If the world is dissatisfied with this method it will have to submit, not to national planning, but to a world dictatorship.

Mr. George Bernard Shaw is a great admirer of the Russian program. In a recent letter to the London Times he said that Russia—

is led by men of impressive ability . . . operating a system from which the disastrous frictions of our continual conflict of private interests and the paralysing delays of our Parliamentary engines of opposition and obstruction have been ruthlessly eliminated.

Is this what the peoples of the world have striven for over the centuries, to set up representative government to protect the rights and liberties of all, only to have Parliamentary safeguards "ruthlessly eliminated" on the specious plea of stabilizing business? What could a dead level of business, stabilized at the expense of progress, offer to the world to compensate for such a surrender of freedom, even of the freedom to make mistakes?

Brazil and the Niemeyer Report

The Brazilian Federal Government announced on September 19, that it would be forced to suspend temporarily the payment of interest charges on all issues of external debts, with the exception of the coupons due Oct. 1 and 15, 1931, on the External Funding 6½ Bonds which will be met. This action, which followed the announcement on August 31 that payments into the sinking fund would be temporarily suspended, was necessitated, the Government states by the severe fall in Brazilian exchange resulting from prevailing economic conditions, both at home and abroad, which made it impossible for the Government to acquire the foreign currencies needed to make these payments. An arrangement has been made with the fiscal agents of the Brazilian government in London to study a plan for meeting the exchange situation.

For those of our readers concerned with Brazil reference is invited to the recently published report of Sir Otto Niemeyer of the Bank of England staff to the Brazilian Government covering Brazilian economic conditions. This report was prepared by Sir Otto and submitted in July, after several months study in Brazil, at the invitation of the Brazilian Government and is a lucid and authoritative analysis of the situation.

In this report, Sir Otto points out that Brazil in common with most other countries has suffered from the abrupt change in overseas lending and the heavy depression of general prices which has characterized the past year or more; also from undue reliance upon issues of notes, expensive borrowings abroad for purposes of doubtful economic value, and excessive public expenditure, all of which produced an inflated financial position to correct which little was done, with the natural and inevitable tendency to a weakening foreign exchange.

He emphasizes the all important necessity of maintaining budgetary equilibrium, both of the States and Federal Government, of placing the railways and telegraph system on a paying basis, and of stabilizing the currency. He

points out the progress already made in balancing the Federal budget by increasing taxation and cutting down expenditures, and states that as a result of measures adopted the 1931 budget should balance and future budgets be met without difficulty so long as expenditure is strictly controlled.

Proceeding to the question of currency stabilization and the banking system, Sir Otto recommends the establishment of a Central Reserve Bank, which shall exercise all the customary functions of a central bank and be free from political control. Capital is to be subscribed for, half by the banks and half by the public in Brazil, in addition to which initial foreign exchange assets of not less than £16,000,000 would have to be provided through the medium of a foreign loan.

Discussing the problem of the trade balance, Sir Otto points out that while the money value of imports and exports have fallen, the balance of the merchandise movement is actually now (at the time of submitting the report) more favorable to Brazil than it has been for some time, as indicated by the following figures: 1927 £9.1 millions; 1928 £6.8 millions; 1929 £8.2 millions; 1930 £12.1 millions; 1931 (first five months) £8.2 millions.* More important, of course, than the balance of trade alone is the balance of payments, both visible and invisible, which include service on the foreign debt. In this connection, he points out that it is normal for a developing country like Brazil to show an unfavorable balance of payments which is necessarily met by continuing investments from overseas, and concludes that there is nothing alarming in this situation provided that new foreign investment is used for strictly productive purposes of a nature likely to increase permanently Brazil's eventual exporting power.

On the subjects of diversification of production and artificial price schemes, Sir Otto expresses decided opinions. He points to the disproportionate role played by coffee in Brazil's economic life and urges the development of other products for which Brazil is well suited. Regarding the coffee valorization, he declares that such policies cannot be continued or repeated, and that in liquidating the present position no further steps should be taken which involve governmental responsibility for the price of coffee or interfere with the natural adjustments and transfer to other production.

* Favorable balance for first seven months 1931 was £12.1 millions.

Finally, Sir Otto concludes his report in the following generally hopeful vein.

> I should not like to close this Report without emphasizing that I have of necessity been mainly concerned in it with those matters which seem to require reform or or reconstruction in Brazil. It is inevitable that a frank discussion of such points which alone can be useful, tends to create an impression that little is right. I should entirely demur to any such inference. Brazil is not alone in facing financial difficulties at the present moment: in many respects her difficulties are less than those of other countries, and she may justly challenge comparison. It is impossible to travel even for a few weeks in the central provinces of Rio, Sao Paulo and Minas without being impressed by her great natural fertility and her undeveloped resources. No country would better repay sound financial administration or is more worth every attempt to keep even in difficult times to high financial tradition: and no country is likely to profit more by the effort, if successfully made.

The Present Situation

The report, while naturally subjected to some criticism, was generally given a favorable reception by the Brazilian public, and the Government is endeavoring conscientiously to put its provisions into effect.

Among the constructive news received from Brazil, has been the report of continued success in balancing the budget, the figures for the first seven months showing a surplus of revenue over expenditures. A legislative Committee is at present working at a problem of closer cooperation between the Federal and individual State Governments. The first step, the abolishment of interstate and intermunicipal duties last summer, is expected to promote the internal trade. The carrying out of the provision regarding the central bank must await, however, a time more propitious for the flotation of a foreign loan.

As to the coffee industry, the present prospects are for the continuation of excessive supplies and consequently low prices. This year's crop (1931-32) will be large, probably around 24 million bags. The Brazilian Government forecast placed the coming two crops 1931-32 and 1932-33 at 39 million bags, which is about 10-12 million bags more than has been the normal two year world consumption of Brazilian coffees.

Present prices of Brazilian coffees (5-8 cents in New York) mean a return of only 1-4 cents to the Brazilian planter after allowances for transportation and the numerous taxes levied against coffee. The effect of this, sooner or later, must be to force high cost producer out of the business. On the other hand, low prices have stimulated consumption and coffee deliveries during the last year (1930-31) surpassed 25 million bags, the highest figure ever reached.

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